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In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 27

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

H. C. GOWRAN

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 30) is reported in 32 B. T. A. 820. The opinion of the Circuit Court of Appeals (R. 56) is reported in 87 F. (2d) 125.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 22, 1936 (R. 60). A petition for rehearing was denied on January 12, 1937 (R. 60). The petition for certiorari was filed April

12, 1937, and granted May 17, 1937 (R. 61). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether a dividend by a corporation in its own preferred stock payable to holders of common, resulting in the alteration of the preexisting proportionate interests of the stockholders in the two classes of stock, constitutes taxable income to the taxpayer under Section 115 of the Revenue Act of 1928.

2. Assuming that such dividend does not constitute taxable income at the time of its receipt, what is the correct cost basis of the dividend stock?

3. In the event that this Court should hold that the stock dividend in question was not taxable at the time of its receipt and that the cost basis of the dividend stock under the circumstances is not zero, the further question is presented whether the case should be remanded to the Board of Tax Appeals for a determination with respect to the application of Section 115 (g), dealing with the redemption of stock under such circumstances that it should be treated as equivalent to the distribution of a taxable dividend.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved will be found in the Appendix, *infra*, pp. 35–40.

STATEMENT

The facts, as found by the Board [1] (R. 32–33), are substantially as follows:

H. C. Gowran, the taxpayer and respondent herein, resides at Two Rivers, Wisconsin (R. 32).

Hamilton Manufacturing Company, hereinafter referred to as the company, was incorporated on February 23, 1926, under the laws of Wisconsin. Article III of its "Articles of Organization" as amended on April 5, 1926, and on December 27, 1928, provides that the company's capital stock shall be divided into 10,000 shares of preferred stock of the par value of $100 each, entitled to a preferential cumulative dividend at the rate of 7 per cent per annum, payable out of net profits; and 30,000 shares of common stock without nominal or par value. Article III further provides that the holders of common stock shall have certain rights and powers, including voting rights, and that the company shall have the right to purchase and redeem any part or all of the preferred stock on the first of January or July in any year, by paying $105 for each share, together with accrued dividends, and that the preferred stock when so redeemed and canceled, may be reissued (R. 32).

On July 1, 1929, the company's common capital stock issued and outstanding, amounted to 18,680.8 shares held by 30 individuals in amounts

[1] As distinguished from the report of a division of the Board (R. 14).

ranging from 1 share to 6,189 shares. Prior to that date its preferred stock, issued and outstanding, amounted to 7,155 shares held by approximately 300 individual stockholders. The taxpayer and the other petitioners before the Board held no shares of the company's preferred capital stock prior to July 1, 1929. On July 1, 1929, the company's earned surplus available for distribution was not less than $444,147.05 (R. 32).

On June 29, 1929, the company's board of directors, at a special meeting, adopted a resolution which, after setting forth that the company's surplus was in excess of $261,531.20, the equivalent of a $14-per-share dividend on 18,680.8 common shares outstanding, and that there remained unissued $261,600 par value preferred stock available for issue by way of stock dividend (R. 32–33), provided in part as follows (R. 33):

> Resolved, by the Board of Directors of Hamilton Mfg. Company, that there be and there hereby is declared a dividend on all of outstanding common capital stock of the company, to the holders thereof of record on July 1, 1929, amounting to $14.00 per share, and that the officers of the company be and they hereby are directed to pay and distribute said dividend forthwith to said stockholders of record, pro rata to each in proportion to his present holdings of common stock, in the form of certificates of the company's preferred stock, each share of

> said preferred stock so distributed to be taken at its par value, viz: $100.

Pursuant to this resolution the taxpayer, who owned 3,812.25 shares of common stock, received 533.715 shares of preferred. The preferred stock so received by the taxpayer on July 1, 1929, had a fair market value of $100 per share on that date (R. 33).

Subsequent to September 1929 the taxpayer agreed to sell to the company at par all the preferred stock issued to him as a dividend, and on or about October 1, 1929, the company purchased at par all such preferred stock, for resale to its employees (R. 33).

The case was originally heard by a division of the Board of Tax Appeals on the question whether the redemption of the stock previously declared as a dividend in the same taxable year was essentially equivalent to the distribution of a taxable dividend under Section 115 (g) of the Revenue Act of 1928. While the division, consisting of a single member, had the case under consideration, the Board decided *Tillotson Manufacturing Co.* v. *Commissioner* (27 B. T. A. 913, affirmed, 76 F. (2d) 189 (C. C. A. 6th)), in which it held that a dividend upon preferred shares payable in common was not a tax-free stock dividend under Section 201 (f) of the Revenue Act of 1926. The Commissioner filed a motion for reconsideration in the instant case because of that decision, and the motion ultimately was granted (R. 28). The case was assigned to

another division and subsequently reviewed by the Board, which held (two members dissenting) that the stock dividend in question was subject to tax at the time of its receipt under Section 115 (f) of the Revenue Act of 1928 (R. 35), and that accordingly it was not necessary to pass upon the question whether the redemption of the stock previously declared as a dividend in the same taxable year was essentially equivalent to the distribution of a taxable dividend under Section 115 (g) of the Revenue Act of 1928 (R. 32).

The taxpayer appealed to the court below, which decided that the stock dividend in question, while constituting income under the Sixteenth Amendment, was exempted from taxation by Section 115 (f) of the Revenue Act of 1928. With respect to the cost basis of the dividend stock, the court decided that it was the value of the stock at the time the taxpayer received the stock dividend, and overruled the Government's contention that the dividend stock had no cost basis because the stock cost the taxpayer nothing (R. 59–60). As to the Government's alternative argument, under Section 115 (g), that the redemption of the stock was essentially equivalent to a taxable dividend, the court apparently adopted (R. 57, 60) the original report of a division of the Board, although the case was afterwards reviewed by the entire Board, which expressly refrained from passing upon that question on the ground that its decision on the construction of Section 115 (f) rendered it unnecessary (R. 32).

On January 11, 1937, the Government filed a petition for rehearing principally on the ground that the lower court erroneously gave effect to the report of a division of the Board after the case had been reviewed by the full Board, which apparently conflicted with the terms of Section 601 of the Revenue Act of 1928 providing that the report of a division shall not be a part of the record in any case in which the chairman directs that such report shall be reviewed by the Board. The lower court denied the petition for rehearing on January 12, 1937. (R. 60.)

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the stock dividend in question was not subject to tax at the time of its receipt under Section 115 (f) of the Revenue Act of 1928 although it represented income under the Sixteenth Amendment.

2. In failing to hold that Section 115 (f) applies only to stock dividends that do not constitute income under the Sixteenth Amendment.

3. In holding that the cost basis of stock previously issued as a stock dividend, which was exempt under Section 115 (f) at the time of receipt, is the value of the stock at the time it was received by the stockholder.

4. In holding that Section 115 (f) was intended to exempt the value of stock dividends from tax at

the time they were sold as well as at the time of receipt.

5. In failing to hold that the cost basis of stock previously issued as a dividend, which might have been taxed as income under the Sixteenth Amendment at the time of receipt, is nothing because it cost the taxpayer nothing.

6. In refusing to remand the case to the Board of Tax Appeals for a determination with respect to the application of Section 115 (g) to the circumstances of this case.

7. In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

1. The dividend in preferred stock paid upon the common stock held by respondent constituted income to respondent within the meaning of the Sixteenth Amendment as settled by this Court in *Koshland* v. *Helvering,* 298 U. S. 441. Such dividend was not exempt under Section 115 (f) of the Revenue Act, which provides that a stock dividend shall not be subject to tax. The intent of Congress will prevail even over the literal wording of a statute, and the intent was to exempt under Section 115 (f) only such stock dividends as were not within Congressional power under the Sixteenth Amendment.

2. The capital gains provisions of the Revenue Act of 1928 direct that the basis of the dividend shares shall be cost. Respondent paid nothing for

the dividend shares and may not, under the *Koshland* case, apportion part of the cost of the original shares to the dividend shares. Hence the cost basis is zero. The analogy of tax free gifts and legacies, relied upon by the court below, is not relevant. This question was properly passed on by the court below and is properly presented to this Court.

3. If this Court should decide against the petitioner on both of the preceding points, we submit that the case should be remanded to the Board of Tax Appeals to determine whether the redemption of the preferred stock was made at such time and in such manner as to be essentially equivalent to the distribution of a taxable dividend under Section 115 (g) of the Revenue Act of 1928. In this case the corporation redeemed the preferred stock three months after it had been issued as a dividend and during the same taxable year. While this question was considered in the original report of the Board, that report was afterwards reconsidered and the final opinion of the Board did not purport to pass upon it. The lower court erroneously gave effect to the report of a division in a case which was vacated by the Board.

ARGUMENT

I

A DIVIDEND BY A CORPORATION IN ITS OWN PREFERRED STOCK PAYABLE TO HOLDERS OF COMMON CONSTITUTES TAXABLE INCOME TO THE TAXPAYER UNDER SECTION 115 (f) OF THE REVENUE ACT OF 1928

1. *Koshland* v. *Helvering,* 298 U. S. 441, held that the payment of a dividend in common stock to a preferred shareholder constituted receipt of income by the preferred shareholder within the meaning of the Sixteenth Amendment. The converse situation here presented of a dividend in preferred stock to a common shareholder is not materially different, and is controlled by the *Koshland* decision. The court below agreed with the Government on this point [2] (R. 58).

In the *Koshland* case, this Court drew a distinction between a stock dividend which works no change in the corporate entity, the same interest in the corporation being represented after the distribution by more shares of precisely the same character, and such a dividend where a different type of shares is issued as dividends, whereby

[2] The Board's opinion in this case preceded this Court's decision in the *Koshland* case. However, in deciding that a preferred stock dividend on common constitutes income, the Board held that there was no material distinction between the instant case and *Tillotson Manufacturing Co.* v. *Commissioner*, 76 F. (2d) 189 (C. C. A. 6th), which, like the *Koshland* case, involved a common stock dividend on preferred (R. 33–34).

the proportional interest of the stockholder after the distribution is essentially different from his former interest.[3] The rule was announced that the payment of a dividend of new common shares on old common, conferring no different rights or interests than did the old—the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the old—does not constitute the receipt of income by the stockholder; but that where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented, he receives income taxable as such under the Sixteenth Amendment. Here, of course, the dividend was not of new common shares to holders of old common. Moreover, it is clear that the preferred stock received by the respondent as a common stockholder conferred rights and interests new and different from those conferred by the common, thus giving respondent an interest different from that which his common stockholdings represented.

Respondent, prior to the dividend, held only common stock. The common stock was without nominal or par value. Only the common stock under any circumstances was entitled to vote. No dividends could be paid on common until all divi-

[3] It is unnecessary in this case, as it also was in the *Koshland* case, to consider the effect of a stock dividend paid to holders of a different class of stock where the dividend did not change the nature and amount of the stockholder's proportionate interests in the corporate assets.

dends present and in arrears had been paid on preferred. In liquidation, distributions on common were subject to prior payment of the par value of the preferred plus, in certain contingencies, any dividends in arrears on the preferred. On the other hand, the preferred stock received by the respondent as a dividend had a par value of $100 per share, was redeemable at $105 plus accrued dividends, was non-voting, and was entitled to an annual preferential cumulative dividend of seven per cent and prior payment on liquidation as aforesaid (R. 9–11, 32).

Just prior to the dividend, the corporation's outstanding common stock amounted to 18,680 shares, of which respondent held 3,812 shares.[4] The preferred stock outstanding consisted of 7,155 shares, of which respondent held none.[5] The total dividend received by common shareholders consisted of 2,615 shares of preferred, of which respondent received 533 shares. Thus respondent, before the dividend, held 3,812 shares of common subject to asset preferences of 7,155 shares of preferred, totaling $715,500 in par value, and an annual preferred dividend charge of $50,085; but

[4] Fractions are omitted in this discussion.

[5] The common and preferred stockholders were substantially different groups, if not entirely so. The common was held by 30 individuals, whereas the preferred was held by approximately 300 individuals. Four individuals, including respondent, who owned 14,453 shares of the total of 18,680 shares of common outstanding, owned no preferred (R. 32–33).

after the dividend held his shares of common stock subject to asset preferences of 9,770 shares of preferred totalling $977,000 in par value, and an annual preferred dividend charge of $68,390. Cf. *Marr* v. *United States,* 268 U. S. 536, 541. Moreover, in addition to the change in the nature of the proportional interest in the net assets and income of the corporation represented by the common shares, respondent acquired for the first time the new and different interest represented by the 533 shares of preferred received as a dividend. The preferred shares gave respondent an interest in net assets of $53,300, and an annual cumulative right to $3,731 in dividends, subject to no priorities, So, too, as a result of the dividend to respondent and other common shareholders, the proportional interests of preferred stockholders in the net assets and income of the corporation were materially altered. Whereas before the dividend the group of three hundred preferred stockholders held the whole preferred stock equities, after the dividend, the group held but seventy-three percent of the preferred stock equities, the balance of twenty-seven percent going to the common shareholders, including respondent (R. 32–33). The preferred stock received by the respondent was thus income within the meaning of the Sixteenth Amendment as settled by the *Koshland* decision.[6]

[6] It would be no answer to argue that respondent received no income because the value of respondent's shares of common decreased in proportion to the value of the preferred

2. The question becomes one of whether the dividend received by respondent, which clearly constituted income within the meaning of the Sixteenth Amendment, was taxed by Congress at the time of its receipt. Subdivision (f) of Section 115 provides that "a stock dividend shall not be subject to tax." It probably will be argued that the dividend here in question is within the literal meaning of subdivision (f), and that this is an end of the matter. But, as Mr. Justice Holmes, speaking for the Court in *Boston Sand Co.* v. *United States,* 278 U. S. 41, 48, has said, the rule that "when the meaning of language is plain we are not to resort to evidence in order to raise doubts * * * is rather an axiom of experience than a rule of law, and does not preclude consideration of persuasive evidence if it exists." Accordingly, this Court has repeatedly held that it is its duty to give effect to the intent of Congress, and that such intent will prevail even over the literal meaning of a statute. *Hawaii* v. *Mankichi,* 190 U. S. 197, 212; *Ozawa* v. *United States,* 260 U. S. 178, 194; *Barrett* v. *Van Pelt,* 268 U. S. 85, 90. And, with specific reference to the income tax statutes, this Court in *Helvering* v. *New York Trust Co.,* 292 U. S. 455, 464, after recognizing the rule that a statute which

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stock dividend received. Even if this were the fact, such is the normal effect of any dividend, whether paid in cash or not. *United States* v. *Phellis,* 257 U. S. 156, 171; *Rockefeller* v. *United States,* 257 U. S. 176, 183.

contains no ambiguity must often be taken literally, said:

> But the expounding of a statutory provision strictly according to the letter without regard to other parts of the Act and legislative history would often defeat the object intended to be accomplished.

Particularly is this the case with respect to the Federal income tax statutes. The particular provisions of a single statute cannot be supposed to be the product of a single draftsman writing at a given moment; the provisions have their roots in earlier statutes, and their modifications are the result of practical experience or judicial decision. This Court has definitively recognized that the construction of a tax statute necessarily involves consideration of the pre-existing tax history. It was stated in *Helvering* v. *Morgan's, Inc.*, 293 U. S. 121, 126:

> But the true meaning of a single section of a statute in a setting as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related sections, or if the mind be isolated from the history of the income tax legislation of which it is an integral part.

See also *Ozawa* v. *United States, supra, Brown* v. *Duchesne*, 19 How. 183, 194.

We submit, if Section 115 (f) be viewed in the light of the previous legislation and judicial deci-

sions upon the question of stock dividends, that it must be taken to mean that only such stock dividends were exempted from taxation as could not be reached within the constitutional power of Congress.[7]

In the Revenue Act of 1913, the first act after the Sixteenth Amendment, Congress defined income as including dividends.[8] But this Court decided in *Towne* v. *Eisner*, 245 U. S. 418, that a dividend on common stock payable in common stock was not income under the 1913 Act. Thereupon in the Revenue Act of 1916, Congress promptly provided in express words that a stock dividend should be considered income to the amount of its cash value.[9] However, *Eisner* v. *Macomber*, 252 U. S. 189, decided in 1920, held that the statute exceeded constitutional power and that a dividend in common stock paid to holders of common stock was not income within the meaning of the Sixteenth Amendment. Accordingly, in the Revenue Act of

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[7] In *Koshland* v. *Helvering*, 298 U. S. 441, the Government argued that this provision must be read literally to exempt from taxation stock dividends of whatever nature. The argument was in considerable part based upon the assumption that the administrative construction of the provision must be given controlling weight in the construction of the statute. This Court did not pass on this question; it did, however, rule (pp. 446–447) that the Treasury Regulations were, in a cognate aspect, invalid. (See *infra*, pp. 23–24.) Our interpretation of the statute has accordingly been revised.

[8] Section II (B), c. 16, 38 Stat. 114, 166, 167.

[9] Section 2 (a) c, 463, 39 Stat. 756, 757.

1921 Congress enacted for the first time the provision that a stock dividend shall not be subject to tax.[10]

The reason for the enactment of the provision exempting stock dividends was compliance with the decision of *Eisner* v. *Macomber*. The House committee report on the Revenue Act of 1921 (H. Rep. No. 350, 67th Cong., 1st Sess., p. 8) states:

> Section 202 (which was finally enacted as Section 201 (d)) modifies the definition of dividends in existing law by exempting stock dividends from the income tax, as required by the decision of Supreme Court in *Eisner* v. *Macomber*.

Senate Report No. 275, 67th Congress, 1st Session, page 9, similarly states that the exemption was required by *Eisner* v. *Macomber*. This Court has recognized that "the reason for the exemption was the decision in *Eisner* v. *Macomber*." *Koshland* v. *Helvering, supra,* at p. 444.[11]

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[10] Section 201 (d), c. 136, 42 Stat. 227, 228. The provision exempting stock dividends, repeated in intervening acts, finally became Section 115 (f) of the Revenue Act of 1928.

[11] In the *Koshland* case the question of whether Congress had taxed such stock dividends as were within its constitutional power was expressly left open. *Koshland* v. *Helvering, supra,* at p. 446. Accordingly, the statement in the opinion (p. 445) that the Treasury and Congress gave *Eisner* v. *Macomber* "a broader interpretation" must be taken to mean, as stated in the preceding paragraph of the opinion (p. 444), that the exemption was "broadly *phrased*." [Italics added.]

Thus the policy and object of the exemption was to comply with the Constitution as interpreted in *Eisner* v. *Macomber*. There is no evidence in the legislative history of the Revenue Act of 1921, or subsequent revenue acts, of a policy behind the exemption of stock dividends other than recognition of a constitutional limitation. Nor do we believe that any other policy of exemption can reasonably be imagined. That the object of Congress in providing the exemption was no broader than meeting constitutional limitation is further evidenced by the fact that in the Revenue Act of 1921, and all revenue acts thereafter, Congress sought to reach distributions which might otherwise be exempted under *Eisner* v. *Macomber* by providing that stock dividends redeemed under such circumstances as to constitute payment of a taxable dividend should be taxed as such.[12] Moreover, the evident

[12] Sec. 201 (d) of the Revenue Act of 1921, 42 Stat. 227, 228; Sec. 201 (f) of the Revenue Act of 1924, 43 Stat. 253, 254; Sec. 201 (g) of the Revenue Act of 1926, 44 Stat. 9, 11; Sec. 115 (g) of the Revenue Act of 1928, 45 Stat. 791, 822; Sec. 115 (g) of the Revenue Act of 1932, 47 Stat. 169, 204; Sec. 115 (g) of the Revenue Act of 1934, 48 Stat. 680, 712; Sec. 115 (g) of the Revenue Act of 1936, 49 Stat. 1648, 1688.

It may be argued that Congress adopted the redemption provision in lieu of taxing any stock dividends, whether exempt under the Constitution or not. But it is significant to note that in the Revenue Act of 1936, where Congress expressly limited the stock dividend exemption to such stock dividends as were not income within the meaning of the Sixteenth Amendment, the redemption provision is retained. See Section 115 (g) of the Revenue Act of 1936, 49 Stat. 1648, 1688.

intent of Congress in income taxation is to use its power under the Sixteenth Amendment to the full extent. *Douglas* v. *Willcuts,* 296 U. S. 1, 9; *Helvering* v. *Stockholms Bank,* 293 U. S. 84, 89; *Irwin* v. *Gavit,* 268 U. S. 161. It is unreasonable to suppose that Congress at the same time and for no apparent reasons of policy intended to exempt stock dividends which were within its taxing power. This Court will not presume an arbitrary largess on the part of Congress. Grants of immunity from taxation are always strictly construed, *Pacific Co.* v. *Johnson,* 285 U. S. 480, 491, and will not be applied beyond the policy sought to be effected, *Helvering* v. *Stockholms Bank, supra.* Here the only policy and reason for enactment of the exemption of stock dividends was compliance with constitutional limitation.

Finally, a short time after the decision of this Court in the *Koshland* case, Congress, in Section 115 (f) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, 1688, specifically provided that a distribution made by a corporation to its shareholders in its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment. On the floor of the House, Representative Vinson, majority member of the Committee on Ways and Means, which reported the 1936 Act, was engaged

in explaining the provisions of that Act when the following significant colloquy occurred:

> Mr. TREADWAY. May I ask the gentleman one question?
>
> I think he has covered subdivision (j) very thoroughly. Now, referring to section (f), taxable stock dividends, which is, of course, entirely new, that is, the principle is entirely new in that there is a set-up there under which stock dividends can be taxed, which has not been in the previous law. I am correct in that?
>
> Mr. VINSON of Kentucky. If the gentleman from Massachusetts will permit, under the 1934 act there was a provision that said no stock dividend should be taxed. In a very celebrated case, Eisner against Macomber, the Supreme Court held that the tax dividend involved in that case was not taxable. Out of that case grew up the idea that no stock dividend was taxable. I think it was because of that notion that the language to which I have referred, as appears in the 1934 bill, found its way there; that is, that no stock dividend should be taxed.
>
> *The proposed plan does not change the law* and does not in the slightest degree strike at the decision of the Supreme Court in the case of Eisner and Macomber in respect of a stock dividend where there is no change in the proportion of ownership by the shareholder.[13] [Italics ours.]

[13] 80 Cong. Rec. 6309 (1936). See also the discussion immediately following the response of Representative Vinson,

The Congressional understanding that the 1936 Act did not change the law is a factor of great weight in construing the prior acts of Congress on the same subject. *Tiger* v. *Western Investment Co.*, 221 U. S. 286, 309; *Cope* v. *Cope*, 137 U. S. 682, 688; *United States* v. *Freeman*, 3 How. 556. The change in language in Section 115 (f) in the 1936 Act does not indicate a change in law, but amounted to a clarification of existing law in order more certainly to effect what has always been the intent and policy of Congress—to exempt such stock dividends as are not within Congressional power and no more.[14] Cf. *Burnet* v. *Guggenheim*, 288 U. S. 280, 283; *Helvering* v. *N. Y. Trust Co.*, *supra*, at pp. 468–469. We therefore submit that the dividend received by respondent, since it was not constitutionally exempt, was taxable at the time of its receipt under the only construction of the statute which gives proper weight to the purpose of Congress.

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which we have quoted above, to the effect that the proposed plan does not change the law. *Id.* pp. 6309–6310. House and Senate reports, and debate in the Senate on the 1936 Act contain no pertinent discussion of the stock dividend provisions, except possibly 80 Cong. Rec. 8811.

[14] The argument may be made that it is not to be presumed that Congress took such "nugatory" action as to exempt only those stock dividends which are constitutionally exempt. But Congress clearly took such "nugatory" action in Section 115 (f) of the Revenue Act of 1936. Legislative statement of a constitutional exemption occurs not infrequently. For example, Congress has consistently exempted from taxation the income accruing to a state, or political subdivision thereof, from the exercise of an essential gov-

Our position is supported by the decision in *Tillotson Manufacturing Co.* v. *Commissioner*, 27 B. T. A. 913, aff'd, 76 F. (2d) 189 (C. C. A. 6th), which apparently was approved by this Court in the *Koshland* case.[15] Both the court below and the Circuit Court of Appeals for the Second Circuit in

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ernmental function. Revenue Act of 1913, 38 Stat. 114, 172; Revenue Act of 1916, 39 Stat. 756, 767; Revenue Act of 1918, 40 Stat. 1057, 1066, Revenue Act of 1921, 42 Stat 227, 238; Revenue Act of 1924, 43 Stat. 253, 268; Revenue Act of 1926, 44 Stat. 9, 25; Revenue Act of 1928, 45 Stat. 791, 823; Revenue Act of 1932, 47 Stat. 169, 205; Revenue Act of 1934, 48 Stat. 680, 712; Revenue Act of 1936, 49 Stat. 1648, 1689.

[15] In the *Tillotson* case, the Board, speaking through Member Sternhagen, was careful to point out that the exemption in subdivision (f) was no broader than the decision of this Court which caused the enactment. The Board said (p. 918):

"When it is realized that the occasion for the original prototype of section 201 (f), namely, section 201 (d) of the Revenue Act of 1921, exempting stock dividends from tax, was the decision of the Supreme Court in *Eisner* v. *Macomber*, *supra*, annuling so much of section 2 (a) of the Revenue Act of 1916 as included stock dividends among those taxable, it becomes clear that the subsequent statutory exemption was only as broad as the decision, and hence that the intention was not to exempt stock dividends by any general or loose concept but only such as could not constitutionally be taxed because they were not income. The term 'stock dividend' is not of itself so free from ambiguity as to preclude construction, and hence the statutory exemption must be construed to promote the intendment disclosed by the history and circumstances of its enactment. This requires that it be confined to such as have the attributes which distinguished them from the receipt of income by the shareholder. Only those which place the shareholder in no essentially different position are exempt."

Pfeiffer v. *Commissioner*, 88 F. (2d) 3, now pending in this Court, No. 29, October Term, 1937, relied upon a literal reading of subdivision (f), and Treasury regulations (see Article 628 of Regulations 74, *infra*, p. 40) and administrative rulings, which are susceptible of the interpretation that all stock dividends, even though not constitutionally exempt, are within the meaning of subdivision (f). But the intent of Congress will prevail even over the literal meaning of a statute, and such intent can no less prevail over administrative interpretation. Moreover, the administrative interpretation of the meaning of "stock dividend" in subdivision (f) was at all times integrated with the apportionment of the cost basis of the original stock between the original stock and the stock received as a dividend thereon. Such apportionment this Court in the *Koshland* case held to be invalid. The broad interpretation of the stock dividend exemption, inextricable from the invalid apportionment of original cost, must also necessarily fail. Judge Learned Hand, dissenting in *Pfeiffer* v. *Commissioner, supra,* states the matter pungently:

> There has therefore never been any administrative interpretation of section 115 (f), so far as I can find, which did not immediately connect it with this method of calculating the "basis"; unless perhaps Article 115–10 (1) of Regulations 86 and its prede-

cessors may be counted."[16] I do not know how far I should have thought these provisions as a whole conclusive; and it is of no consequence, for *Koshland* v. *Helvering, supra,* 298 U. S. 441, 56 S. Ct. 767, 80 L. Ed. 1268, 105 A. L. R. 756, has settled it that so far as they affect the "basis", they have been invalid from the beginning. Thus, the only question now is whether though invalid as to that, they may still be authoritative in interpreting section 115 (f) taken alone. I cannot think that we should blow hot and cold; if the effort indirectly to charge the taxpayer with the new shares under the guise of diminishing his "basis" must break down, any concomitant interpretation as to exemption of the shares, qua income, ought to fall with it. * * *

[16] [Our footnote.] Article 115–10 (1) of Regulations 86 does not purport to interpret the meaning of subdivision (f) but merely provides:

"ART. 115–10. Source of tax-free distribution of stock or securities in corporate reorganization: The general rule provided in section 115 (b), that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

"(1) A stock dividend. See section 115 (f)."

II

ASSUMING THAT THE STOCK DIVIDEND IN THIS CASE DOES NOT CONSTITUTE TAXABLE INCOME AT THE TIME OF ITS RECEIPT, THE CORRECT COST BASIS OF SUCH STOCK IS ZERO

If this Court should decide that the dividend of preferred stock, although income under the Sixteenth Amendment, was exempt under Section 115 (f) and so was not taxable when received, we submit as an alternative argument that the entire proceeds of the sale of the preferred by respondent to the corporation (R. 33) represented taxable gain.

1. The *Koshland* case presented essentially the same situation as that here: the receipt by the taxpayer of a stock dividend which constituted income under the Sixteenth Amendment. The question there arose as to what the basis should be upon sale by the taxpayer of the original shares, with respect to which the dividend was declared. This Court pointed out that the relevant capital gains provisions of the Revenue Act of 1928, Sections 111 (a) and 113, *infra*, pp. 35–37, plainly required a cost basis, that the requirement of a cost basis could not be changed by regulation, and held that the cost of the original shares could not be apportioned between the original shares and the dividend shares. Here respondent sold the dividend shares, and under the same plain provisions of the Revenue Act of 1928 the basis for such shares must be their cost. But

the respondent paid nothing for the dividend shares, and since the cost of the original shares may not under the *Koshland* decision be apportioned to the dividend shares the cost basis of the dividend shares is necessarily zero. Hence the entire proceeds of the sale of the dividend stock to the corporation constituted taxable gain.

The court below decided that the basis of the dividend stock was its value at the time of receipt by respondent. That result was predicated upon an analogy to tax-free gifts and legacies. The basis for tax-free gifts and legacies is specifically prescribed by statute. But there are no similar provisions applying to stock dividends, and nowhere in the applicable Revenue Act of 1928 is there authority to depart from the plain requirement of Section 113. Bases for gifts and legacies are provided for by Section 113 in the form of exceptions to the rule laid down in that section that the basis upon disposition of property acquired after February 28, 1913, shall be cost. This Court noted in the *Koshland* case (p. 446) that the exceptions to the Section 113 requirement of cost basis have no relevance in a situation such as that here presented. Moreover, the analogy between tax-free gifts [17] and devises on the one hand and

[17] It should be noted that at least so far as gifts made after December 31, 1920, are concerned Section 113 (a) (2) provides not for a basis of fair value at the time of receipt but for the same basis as that of the donor or last preceding owner not acquiring the property by gift.

stock dividends on the other is not apt, because the reason for adopting the value at the time of acquisition as the basis for gifts and legacies is not present here. The value of a gift is subject to a gift tax and the value of legacies is subject to an estate tax. Hence, gifts and legacies would be subjected first to an estate or gift tax and then to an income tax upon capital gain, unless the basis for determining gain or loss were value at the time of acquisition. While double taxation is not invalid, Congress clearly followed a policy of avoiding what would in substance be double taxation of gifts and legacies. But there is no occasion for or evidence of a similar policy in the case of stock dividends. Here, instead of relief from double taxation, the adoption of value at the time of receipt as the basis for the dividend shares will result in a complete exemption from tax for no apparent reasons of policy at all.

2. The respondent suggests (Br. in opp. 6–7) that the question of the cost basis of the preferred stock has not been properly raised. The Circuit Court of Appeals passed upon this question (R. 59–60), and it is presented to this Court in the petition for certiorari (Pet. 10–12). The record contains all the facts necessary to a decision. There was no want of power in the court below, nor would there be any lack of power in this Court, to pass upon this question, which is clearly one of law alone with no mixed element of fact. *Langnes* v. *Green*, 282 U. S. 531, 537–538. In the light of the circum-

stances of the litigation, we submit that the court below properly passed upon the question.

The taxpayer's return showed a capital net gain in the amount of $27,262.72, reporting profit realized on the redemption of 533.715 shares of Hamilton Manufacturing Company preferred stock. The Commissioner determined that the redemption was essentially equivalent to the distribution of a taxable dividend under Section 115 (g), and hence eliminated the capital gain, and increased income from dividends in the amount of $53,371.50 (R. 5–7).

After the filing of pleadings before the Board, and during consideration by Board Member McMahon of the issue of the redemption as a taxable distribution under Section 115 (g), the Board on March 11, 1933, decided the *Tillotson* case, *supra*. Accordingly the Commissioner advanced the argument sustained in that decision that a dividend such as that in question is taxable at the time of its receipt. The *Tillotson* case was affirmed by the Circuit Court of Appeals for the Sixth Circuit on March 14, 1935. On June 27, 1935, the Board followed the *Tillotson* case and agreed with the Commissioner that the dividend was taxable at the time of its receipt. In view of the *Tillotson* decision by the Board, and its affirmance in the Sixth Circuit, the Commissioner reasonably relied before the Board on the theory that the dividend was taxable at the time of its receipt. There was then no occasion to make the alternative argument premised upon

error in the theory that the dividend was taxable as income at the time of receipt. But if the Board had refused to follow the *Tillotson* case and had decided that the dividend was not taxable as income, there could have been little question of the propriety of the Board's granting a hearing to the Commissioner on the question of the cost basis which would have then been raised because of the Board's adverse decision.

The appeal in this case was to the Seventh Circuit, and before argument in the court below, this Court in the *Koshland* case had prescinded the question of the taxability of the dividend as income at the time of receipt. Accordingly, the Commissioner diligently anticipated a possible adverse decision on that question and argued the question of cost basis as a resulting alternative. The position of the taxpayer was in no way prejudiced by the presentation of the cost basis question since it was one of law, and taxpayer, who was afforded opportunity to answer the argument, could have added no new facts in support of his position had the question been presented before the Board. The absence of prejudice to the taxpayer is further demonstrated by the fact that the decision of the court below on the cost basis question was favorable to the taxpayer. Nor was the Commissioner seeking to secure a *reversal* of the Board's decision on a theory not presented to it. *General Utilities Co.* v. *Helvering,* 296 U. S. 200, and *Helvering* v. *Salvage,* 297 U. S. 106, are thus inapplicable. The

situation is rather to be viewed as an example of the familiar rule that any argument may be offered in support of the judgment below.[18] *United States* v. *American Ry. Express Co.*, 265 U. S. 425, 435–436; *Langnes* v. *Green*, 282 U. S. 531, 537–538; *Stelos Co.* v. *Hosiery Corp.*, 295 U. S. 237, 239. As such, and in view of all the circumstances, the court below properly passed on the argument of cost basis.

Finally, the court below has decided the question of cost basis, and we submit, erroneously. Should this Court decide against the Government on the taxability of the dividend at the time of receipt, clearly it would be desirable for both the Government and taxpayers in general that the further question of cost basis which is thus raised be decided now. We do not believe that the Court should in such circumstances apply a rule so harsh as to preclude consideration of a question which was anticipated at the earliest reasonable opportunity, passed on by the court below, and duly presented in the petition, especially where consideration of the question did not and cannot result in prejudice to the taxpayer's defense.

[18] The decision of the Board, entered pursuant to rule 50, was to the effect that there is a deficiency of $5,831.67 in the respondent's income tax for the year 1929 (R. 45). Had the transaction been taxed as a capital gain the deficiency would have been somewhat less.

III

IF THIS COURT SHOULD DECIDE POINTS I AND II ADVERSELY TO THE GOVERNMENT, THE CASE SHOULD BE REMANDED TO THE BOARD OF TAX APPEALS TO DETERMINE THE APPLICATION OF SECTION 115 (g) TO THE CIRCUMSTANCES OF THIS CASE

In this case the corporation redeemed the preferred stock three months after it had been issued, and during the same taxable year (R. 33). If this Court should decide against the petitioner on both of the preceding points, we submit that the case should be remanded to the Board of Tax Appeals to determine whether the redemption of the preferred stock was made at such time and in such manner as to be essentially equivalent to the distribution of a taxable dividend under Section 115 (g) of the Revenue Act of 1928, *infra*, p. 38.

At the original hearing before a division of the Board of Tax Appeals the sole question was whether the redemption of the preferred stock, previously declared as a dividend in the same taxable year, was essentially equivalent to the distribution of taxable dividend under Section 115 (g) of the Revenue Act of 1928 (R. 14). While the division, consisting of a single member, had the case under consideration, the Board decided *Tillotson Manufacturing Co.* v. *Commissioner, supra,* in which it held that a dividend upon preferred shares payable in common was not a tax-free stock dividend under Section 201 (f) of the Revenue Act of 1926,

and that the cost basis of the preferred shares could not be reduced on account of the dividend. After an adverse decision by the Division, the Commissioner filed a motion for reconsideration in the instant case because of the *Tillotson* decision (R. 22–25). The motion was denied by the Division (R. 25) but on review by the Board this order was vacated and reconsideration of the original memorandum opinion was granted (R. 28). The case was assigned to another division and subsequently reviewed by the Board, which held (two members dissenting) that the stock dividend in question was subject to tax at the time of its receipt under Section 115 (f) of the Revenue Act of 1928 (R. 35), and that accordingly it was not necessary to pass upon the question whether the redemption of the stock previously declared as a dividend in the same taxable year was essentially equivalent to the distribution of a taxable dividend under Section 115 (g) of the Revenue Act of 1928 (R. 32).

The Board said (R. 32):

> If it be determined that the dividend was not a tax-free stock dividend when made on July 1, 1929, and therefore properly includable in income, that conclusion would be decisive here without passing upon the question of whether there was a redemption within the meaning of Section 115 (g) of the 1928 Act.

Section 601 of the Revenue Act of 1928, *infra*, p. 39, provides in part that the report of a division shall not be a part of the record in any case in which the chairman directs that such report shall be reviewed by the Board. Inasmuch as the report was expressly ordered by the entire Board to be reconsidered (R. 28, 31), it is our understanding that the report of the division has no subsequent legal effect whatsoever. Nevertheless the lower court said in its opinion that the majority of the Board did not overrule the conclusion reached June 29, 1933, in which it was held that the preferred shares had not been redeemed in such manner as to make the transaction essentially equivalent to a taxable dividend (R. 57), and failed to remand the case for a decision by the Board on the point. We submit in view of the express order and opinion of the Board, that this was error. A decision which has been ordered to be reconsidered cannot be said to be the decision of the Board.

CONCLUSION

The lower court erroneously construed the term "stock dividend" in subdivision (f) of Section 115 of the Revenue Act of 1928 to include any stock dividend, whether it represented income under the Constitution or not. If, however, this Court should decide that the stock dividend was not taxable at the time of receipt, the cost basis of the dividend stock is zero. If this Court decides against the petitioner on both of these grounds, the

case should be remanded to the Board of Tax Appeals to pass upon the application of Section 115 (g).

Respectfully submitted.

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OCTOBER 1937.

APPENDIX

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS.

(a) *Computation of gain or loss.*—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in section 113, and the loss shall be the excess of such basis over the amount realized.

* * * * * *

SEC. 113. BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Property acquired after February 28, 1913.*—The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—

* * * * * *

(2) Gift After December 31, 1920.—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the fair market value of such prop-

erty as found by the Commissioner as of the date or approximate date at which, according to the best information that the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner;

(3) Transfer in Trust After December 31, 1920.—If the property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a bequest or devise) the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made;

(4) Gift Or Transfer In Trust Before January 1, 1921.—If the property was acquired by gift or transfer in trust on or before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition. The provisions of this paragraph shall apply to the acquisition of such property interests as are specified in section 402 (e) of the Revenue Act of 1921, or in section 302 (f) of the Revenue Act of 1924 or the Revenue Act of 1926 (relating to property passing under power of appointment) regardless of the time of acquisition;

(5) Property Transmitted At Death.—If personal property was acquired by specific bequest, or if real property was acquired by general or specific devise or by intestacy, the basis shall be the fair market value of the property at the time of the death of the decedent. If the property was acquired by the decedent's estate from the decedent, the basis in the hands of the estate shall be the fair market value of the property at the time

of the death of the decedent. In all other cases if the property was acquired either by will or by intestacy, the basis shall be the fair market value of the property at the time of the distribution to the taxpayer. In the case of property transferred in trust to pay the income for life to or upon the order or direction of the grantor, with the right reserved to the grantor at all times prior to his death to revoke the trust, the basis of such property in the hands of the persons entitled under the terms of the trust instrument to the property after the grantor's death shall, after such death, be the same as if the trust instrument had been a will executed on the day of the grantor's death;

* * * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term "dividend" when used in this title (except in section 203 (a) (4) and section 208 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the basis of the stock provided in section 113.

(c) *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed in partial liquidation (other than a distribution within the provisions of section 112 (h) of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

* * * * *

(f) *Stock dividends.*—A stock dividend shall not be subject to tax.

(g) *Redemption of stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend. In the case of the cancellation or redemption of stock not issued as a stock dividend this subsection shall apply only if

the cancellation or redemption is made after January 1, 1926.

(h) *Definition of partial liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

* * * * *

SEC. 601. BOARD OF TAX APPEALS—PROCEDURE.

Sections 906 and 907 (a) and (b) of the Revenue Act of 1924, as amended, are further amended to read as follows:

"SEC. 906. (a) The chairman may from time to time divide the Board into divisions of one or more members, assign the members of the Board thereto, and in case of a division of more than one member, designate the chief thereof. If a division, as a result of a vacancy or the absence or inability of a member assigned thereto to serve thereon, is composed of less than the number of members designated for the division, the chairman may assign other members to the division or direct the division to proceed with the transaction of business without awaiting any additional assignment of members thereto. A division shall hear, and make a determination upon, any proceeding instituted before the Board and any motion in connection therewith, assigned to such division by the chairman, and shall make a report of any such determination which constitutes its final disposition of the proceeding.

"(b) The report of the division shall become the report of the Board within 30 days after such report by the division, unless

within such period the chairman has directed that such report shall be reviewed by the Board. Any preliminary action by a division which does not form the basis for the entry of the final decision shall not be subject to review by the Board except in accordance with such rules as the Board may prescribe. The report of a division shall not be a part of the record in any case in which the chairman directs that such report shall be reviewed by the Board.

* * * * *

Treasury Regulations 74, relating to the Revenue Act of 1928:

ART. 628. *Stock dividends.*—The issuance of its own stock by a corporation as a dividend to its shareholders does not result in taxable income to such shareholders, but gain may be derived or loss sustained by the shareholders from the sale of such stock. The amount of gain derived or loss sustained from the sale of such stock, or from the sale of the stock in respect of which it is issued, shall be determined as provided in articles 561 and 600.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1936.

No. [redacted] 27

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

H. C. GOWRAN.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

THE GUNTHORP-WARREN PRINTING COMPANY, 310 WEST JACKSON, CHICAGO

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In this brief the petitioner above named will be sometimes referred to as the Commissioner of Internal Revenue, or as the Commissioner, and the respondent, H. C. Gowran, will be sometimes referred to as the taxpayer.

OPINIONS BELOW.

The opinion of the Board of Tax Appeals (R. 39) is reported in 32 B. T. A. 820. The opinion of the Circuit Court of Appeals (R. 75) is reported in 87 F. (2d) 125.